EUROPEAN CENTRAL BANK

EUROSYSTEM

DG/MARKET OPERATIONS
BMI/EBM

ECB-PUBLIC
3 February 2016

Bond Market Contact Group

Frankfurt am Main, Tuesday, 19 January 2016, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Electronic trading and growth of automated trading strategies

Frank Engels (Union Investment) and Zoeb Sachee (Citi) reviewed the usage of electronic trading platforms and automated trading strategies in European fixed income markets. Martin Scheck (International Capital Market Association) complemented the analysis by introducing the ICMA Electronic Trading Platform (ETP) Mapping Study published in October 2015.

The members of the Bond Market Contact Group (BMCG) deemed that the market infrastructure for European government bonds – with multi-dealer platforms dominating electronic trading – in effect limits the use of automated trading strategies, such as those involving high-frequency trading (HFT) in the cash markets. This contrasts with the market for US Treasury securities, as well as US and German bond futures markets, where automated trading accounts for an increasingly larger share of secondary market trading. The limited use of automated trading strategies for European government bonds was attributed to the wide range of issuers and non-standard maturities, and also the predominance of multi-dealer platforms (these typically use request-for-quote protocols, have highly manual processes, and feature a lower speed of execution and less access to order books).

There were mixed views regarding the usefulness of the fast growth and prevalence of automated trading strategies in the markets for US Treasuries and US and German bond futures. On the one hand, increased automation has had some advantages, including a reduction in trading costs, more counterparty diversification and possibly more accurate pricing, which could allow for a quicker correction of price distortions. On the other hand, automated trading strategies following specific algorithms also pose some risks that should be monitored: (i) they increase market vulnerability and may possibly lead to greater volatility owing to the very quick pace of trading involved; (ii) they increase the risk of front running of client orders; (iii) they may encourage market manipulation strategies; and (iv) they could accentuate the reduction in market liquidity, particularly in periods of high volatility when the apparent liquidity suddenly disappears. Group members argued that these risks should be mitigated by the development of best practices (a task to be undertaken by regulators) and by monitoring the actions initiated by platforms to ensure smooth trading and efficient circuit breakers.

2. Bond market outlook and other topics of relevance

Franck Motte (HSBC) reviewed the main developments that have affected bond markets since the last meeting, as well as the outlook and issuance prospects for 2016.

The discussion revealed divergent views on the impact of the large decline in commodity prices, the possible slowdown in emerging market growth and growing geopolitical risks. The majority of members expected the decrease in commodity prices to lead to higher consumer demand and net growth in most advanced economies; a development which would more than compensate for the negative impact of the slowdown in oil-exporting economies. However, several members warned that financial markets were complacent regarding the second-round effects and the risk implications of the quick oil price adjustment vis-à-vis the global banking exposure to some highly indebted countries and sectors, as well as the risks related to a further depreciation of the Chinese renminbi. Some members also noted emerging signs of a downturn in the US economic cycle, including the deceleration in US corporate profitability, tighter loan standards and the slowdown in capital expenditure and employment growth suggested by some manufacturing surveys. In addition, according to some members, the expanded asset purchase programme (APP) has helped in keeping euro area bond markets isolated from developments in the US bond market, except in the high-yield credit segment. Still, members expected the European Central Bank (ECB) and the Bank of Japan to ease monetary policy further in the coming months.

The full implementation of the EU's Bank Recovery and Resolution Directive – the Single Resolution Mechanism (SRM) became fully operational as of January 2016 – was seen as a positive step towards the banking union and towards building confidence in the robustness of the European banking sector. However, members of the BMCG recommended that further clarity be provided regarding the future application of the bail-in mechanism in order to reduce legal uncertainty and market fragmentation.

3. Transmission of the APP and inflation measures

Christoph Rieger (Commerzbank) and Michael Krautzberger (BlackRock) analysed the transmission of the APP of the ECB. The presentation was complemented by Thomas Werner's (ECB) analysis of the recent developments regarding marked-based indicators of inflation expectations.

The preliminary analysis vis-à-vis the transmission of the APP pointed to rather limited success for now, at least in terms of reaching the ultimate objective of the ECB's monetary policy. During the discussion, several Group members noted the improvement in some macroeconomic indicators (e.g. purchasing managers' indices (PMIs) and unemployment trends) and recalled that inflation has been subject to a number of negative exogenous shocks since the launch of the APP.

Some members claimed that bond market depth has worsened and is currently at multi-year lows in terms of the average trade size (per duration). The deterioration is more acute for longer maturities: while large investors' portfolios have expanded steadily, there has been a general reduction in the balance sheet capacity of dealers owing to regulatory changes. The lower market depth was expected to lead to more frequent periods of heightened price volatility in bond markets.